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Some Aspects of a Purchase of a Business Out of Earnings

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My topic this afternoon concerns the purchase of a business out of earnings.

It may seem an anomaly that a business can be purchased out of earnings, but in fact many businesses are purchased with relatively small initial payments, the balance paid later from retained earnings after taxes. Since taxes are a large factor in cash dissipation, that is, cash which could be otherwise used to liquidate indebtedness incurred in the purchase, the general content of this paper will be the tax problems incident to the form of acquisition and factors which should influence the business operations thereafter.

BUSINESS CHARACTERISTICS

Since a business is to be purchased it must be assumed that an existing business is already in operation which its owners wish to sell, and which its purchasers wish to buy with as little cash outlay as possible. It must be assumed for this purchase that the business is a profitable one, or one which the purchasers believe can be made profitable. If the business is profitable there may be a question as to why the owners wish to sell. Typically, reasons for such sales can be found in the following:

- Advanced age of the owners, with lack of successor management.
- Estate tax problems faced by the principal owners.
- Realization by high-bracket-taxpayer owners that the only way in which they can realize on their investment and still retain part of the proceeds is by a capital gains transaction; that is, by a sale.
- Realization by the operators that the business is not going well and that they are unable to make it do well, but our prospective purchaser believes he is in a position to do so.

The typical business with which the first three sellers would be concerned would be a corporation which has been in operation for a considerable period, with low-cost-basis assets, very little debt, and profits which force payment of dividends because of the hazards of the accumulated earnings tax. In these situations, the company is what may be called a "fat corporation." It has assets which can be used by the purchasers as collateral for loans and, in some cases, cash in excess of the business' needs, which would be readily available for at least a partial payment of the purchase price. Frequently in these situations the sellers are willing to accept notes or other evidences of indebtedness for at least a portion of the sale price.

The fourth type of business – that is, the relatively unsuccessful business – has different characteristics. Frequently it has high-basis assets which are not able to earn effectively, it may have a net operating loss, and possibly a deficit in earnings and profits. Its owners are willing to sell, largely to get out from under, and usually they are willing to accept even a larger portion of the purchase price in notes or other evidences of indebtedness. Usually in these cases there are few assets which are available for pledge, or any material amount of cash available for payment on the purchase price. It is apparent that the purchaser of this type of business is in a far different situation from the purchaser of the fat business. Hence, the procedures and tax problems are materially different. The two types of businesses will be discussed separately.

REQUIREMENTS OF PURCHASERS

The principal characteristic of a purchaser who wishes to pay for the business out of earnings is his desire to advance the minimum of cash at the outset. He may be a shoestring operator or he may be a group of wealthy high-bracket taxpayers, but by definition he wishes to devise a method of business acquisition suited to his needs which will permit him to own the business with only a small down payment. The procedure in making a business pay for itself out of its earnings will of necessity vary greatly, depending upon the number of purchasers, their income brackets, the amounts included in the purchase price, estimated future earnings, and other factors which will determine the tax payable by the purchased business.

ORGANIZATIONS SUITED TO NON-CORPORATE FORM

If a small group buys a small business, whether a corporation or otherwise, and none of the purchasing group is in high tax brackets from outside income, it may be best to operate the purchased business in sole-proprietor or partnership form. Tax considerations are weighed here only;

other more cogent reasons may require incorporation. If in partnership form it may be that a limited partnership can be used to advantage, and, of course, in some types of business, incorporation is not permitted. Usually it is a matter of simple arithmetic to determine the relative tax impact of a corporation and an unincorporated operation, based upon the anticipated income, proposed salaries, and income tax payable under the varying forms. If it is a business in which the aggregate tax load in corporate or non-corporate form is about equal, then it is usually advisable not to incorporate, because of the double tax inherent in corporate operation.

If the purchased business had been operated by a corporation and the basis of the assets in the hands of the purchased corporation was low, it is likely that the corporation purchased should be liquidated, thus stepping up the basis of the assets to an amount equivalent to the purchase price of the stock.[1] If a partnership, perhaps a limited income participation for a period could be used as part payment. Generally speaking, however, the tax problems with which we are concerned will occur in acquisitions which will be owned by corporations, either because income to be realized through operation of the business is greater than can be received by non-corporate taxpayers, or because the purchasers are high bracket taxpayers who do not wish to add to their already too-high tax rates.

ACQUISITION OF FAT CORPORATION STOCK

As indicated earlier the purchase of the fat corporation and the skinny corporation present very different problems. The fat corporation normally will have no net operating losses, nor will it have a deficit in earnings and profits; and it will have low-basis assets, ample cash, and generally be liquid in character. It is apparent that the purchase of stock of such a corporation and its continued operation would be foolish. A major need is to get the debt and the ownership of the assets related so that the profits can be used to pay off the debt, and at the same time obtain as much depreciation and other deductions as possible, so as to minimize taxes in the early years when cash payments on the purchase are required. The general program in such a case is to form a new corporation and to transfer to that corporation in exchange for stock, as much cash or other assets as necessary to consummate the purchase. The new corporation then purchases the stock of the corporation to be acquired, in a taxable transaction, borrowing money from banks or others or giving notes to the sellers, or a combination of both. It is possible in some cases that preferred stock could

[1] IRC P 334(a).

be issued to the sellers, but generally in situations of this sort notes would be preferable, because the interest on such payments are deductible. Over 80 per cent of the stock of the new company having been acquired, within two years after the purchase of the stock the purchased company is liquidated or merged into the parent company. After merger, the new company owns all of the assets of the old company and is subject to the debts incurred to purchase. If there are excess or other assets or if there are assets availablė for sale and lease-back, or for pledge, cash can be freed rapidly to liquidate debt without impairing the profit-making capacity of the business. This type of liquidation will result in an increased basis of assets because the purchase price of the stock will be allocated to the assets so acquired.[2] This basis step-up usually will increase depreciation deductions, possibly increase inventory values and thus increase cost of goods sold and permit sale of unneeded assets at small gains. Sale and lease-back transactions will be possible without large capital gains which would have been payable had the liquidated corporation made the sale. Thereafter profitable operations will produce income which will be taxed at corporate rates, the excess after taxes being used largely to liquidate the debt incurred in acquiring the business. There will be no problem about the retained earnings tax because the business will have a reasonable need for the retention of funds to pay off debt.

At the time of the acquisition of the new company, its operations should be examined carefully to determine whether they are such that a number of corporations, rather than a single corporation, can be used. If its operation lends itself to multiple corporations, then consideration should be given to the creation of subsidiaries to operate various parts of the business, thus obtaining additional surtax exemptions. The business purpose for subsidiaries must be considered carefully; if the subsidiaries are created principally for tax reasons there is a strong probability that the additional surtax exemptions will be denied.[3]

ACQUISITION OF OPERATING ASSETS

Instead of selling stock, it may be that the selling corporation would be willing to sell assets. The purchaser (if the estimates of income warrant corporate operation) would form a corporation to acquire the business assets. Here, no corporate liquidation would be required and only the desired assets would be purchased, thus reducing the purchase price. Such

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2 IRC P 334(b)(2)(B).
3 IRC P 1551.

a purchase would be feasible from the standpoint of the sellers if they adopted a plan of liquidation and sold the assets and liquidated within a year. This procedure would avoid a double tax on the sale both of their inventory and of their depreciable and non-depreciable assets.[4]

The purchase price of assets acquired would fix the basis to the purchaser corporation and thereafter the problems and procedure would be similar to the situation after liquidation of the corporation purchased. For example, the purchasing corporation might effect a sale and lease-back of the real property or even machinery; it would certainly be advisable, if such assets were to be retained, to endeavor to obtain the highest possible depreciation in early years so as to generate cash from depreciation allowance. It should be noted here as to both situations that the new depreciation methods, double declining balance and sum of digits, would not be available to such a purchaser on assets purchased because the assets had their first use by another taxpayer.[5] However, being used assets, they might well have much shorter useful lives and the net effect would be increased deductions even on a straight-line basis. Likewise inventories would be purchased at more nearly market value and their sale would constitute a return of purchase price with which inventory could be repurchased; this should result in a minimum of taxable income.

Essentially there is little difference between the acquisition of a company in a taxable transaction followed by its liquidation and the acquisition of assets in a taxable transaction. The key in both cases will be an operation in which debt is a prominent factor and in which corporate earnings after taxes are used to liquidate the debt incurred in the purchase.

NON-TAXABLE EXCHANGE ACQUISITIONS

In corporate acquisitions of fat corporations the acquiring corporation usually wishes a taxable transaction. If the acquisition is achieved in a tax-free reorganization, then the basis of the stock of the acquired corporation is the same as the basis of the transferors, and if the acquired corporation is liquidated or merged into the acquiring corporation, the basis of the assets in the hands of the acquired corporation becomes the basis to the acquiring corporation.[6] In our assumptions as to this type of acquisition, it was assumed that the basis of the stock in the hands of the sellers was low and that the basis of the assets in the hands of the acquired corporation likewise were low. The result of the tax-free acquisition in a reorgani-

4 IRC P 337.
5 IRC P 167(c)(2).
6 IRC P 361(a) and 362.

zation of such a company is unfavorable to the acquiring company and generally the purchaser will balk at acquiring low-basis assets at full market price. Sometimes in order to assure the sellers of a tax-free transaction the exchange ratio will be such as to adjust for the disparity between the basis and the purchase price, but often this is unsatisfactory both to the buyer and to the seller. Since the purchaser is assumed to wish to acquire the business from its own earnings, a reorganization in which the selling stockholders receive stock in the acquiring corporation normally would not be used.

ACQUISITION OF STOCK *vs.* ASSETS

BASIS CONSIDERATIONS

The situation with respect to skinny corporations is fundamentally different, and its difference will have a great bearing upon the mechanics of the purchasers. Here, we assume that the corporation to be purchased has had relatively low profits or losses, that its assets have a high basis rather than a low basis and that there may be a net operating loss available if it can be used by the purchasers. Under such circumstances it would generally be advisable for the purchasers to acquire the stock of the old corporation, provided that they are satisfied the corporation has a sound business. Again we assume that debt must be used to acquire the corporation, so that it will probably be necessary to have the corporation acquired by a new corporation which borrows a portion of the purchase price either from financial institutions or by giving notes to the sellers. This type of acquisition is considerably more difficult because of the desire of the Treasury Department to eliminate the "traffic in loss corporations."

If the purchase is a taxable transaction and the purchase price is less than the aggregate basis of the assets purchased, then its liquidation within two years will bring the transaction under the Kimbell-Diamond Rule [7] and the purchase price will be allocated over the assets of the liquidated corporation. This generally will be undesirable because it will result in a loss of basis. Yet, on the other hand, some means must be found to permit the acquiring corporation to pay interest and principal installments on debt incurred in the purchase. Since the interest payments will be deductible, dividends declared by the acquired corporation for interest will be no problem, but dangers of a personal holding company classification will occur where dividends are distributed and used to pay installments of debt.

[7] IRC P 334(b).

This can be avoided by the use of a consolidated return [8] at a 2 per cent penalty and after the corporations have operated for more than two years the subsidiary can be liquidated under the general rule, and thus retain high basis for the assets.

If the purchasers are in high tax brackets and willing to use personal funds to pay interest and principal payments on the purchase-price debt, there would be no necessity for a holding company. If the debt payments can be postponed for a two-year period, interest payments during that period would be advantageous to the purchasers as personal deductions. After the two-year period the purchased stock encumbered by the debt could be transferred to a new corporation for stock and later merged so as to place the operations and debt in the same corporation. Since the transfer to the new corporation was tax-free,[9] the holding period of the transferors becomes the holding period of the new corporation and the corporation can be liquidated under the ordinary rule of Sec. 332. This will preserve the basis of the assets of the acquired corporation.[10]

NET OPERATING LOSSES

If the acquired corporation has a net operating loss and the purchase is a taxable transaction, then Section 382(a) will apply in determining whether the net operating loss will be available to the purchasers of the stock. (It is assumed that over 50 per cent of the stock of the purchased company will be acquired.) The acquisition thus will satisfy the stock-purchase requirements of Section 382(a). To avoid disallowance of its net operating loss the acquired corporation must continue to operate in the same place and in the same manner as it was operated previous to the change of stock holding. If the disallowance provisions of Section 382(a) can be avoided the net operating losses of the preceding management can be used to eliminate tax on new profits and thus make available more funds for payment on the purchase price of the business. (Unfortunately not even tentative regulations have been issued on Section 382 as yet and the scope of the Section is uncertain, to say the least.) If it is not possible to operate in the same manner in the same place, and otherwise qualify under the third subdivision of Section 382(a), then the net operating loss will be denied, but the company presumably will have the benefit of the depreciation on relatively high-basis depreciable assets and high inventory values as a source of cash to pay off part of the purchase price. In order

8 IRC P 542(b)(2).
9 IRC P 351.
10 IRC P 334(a).

to preserve such assets, however, the acquired corporation cannot be liquidated within two years after its acquisition.[11]

Another danger confronts the acquiring corporation if the basis of the assets acquired and the tax loss are substantially greater than the purchase price. Section 269 (which is the successor to Section 129 of the 1939 Code) raises the same imponderable difficulty providing an additional weapon for the government in a prima-facie presumption that a purchase for substantially less than the basis and tax benefits acquired would be indicative of a motive to avoid taxes. The scope of this Section (and also Section 382) is extremely uncertain, because not even tentative regulations have been issued by the Treasury Department in connection with such transactions.

Thus the acquisition of a weak or skinny corporation usually makes it desirable to maintain the purchased corporation as a corporation, and not to buy its assets in a taxable transaction. If a non-taxable transaction is possible or desired by the owners, then the acquisition of substantially all the assets, or the acquisition of over 80 per cent of the stock, in exchange for the stock of the acquiring corporation could be utilized to preserve the basis and in many cases the net operating loss. If the acquisition was a stock-for-stock situation the acquired corporation would maintain its own net operating loss and could utilize it against operating income when earned. If the acquisition was a C-type reorganization (stock for substantially all the assets),[12] then the net operating loss would be allowed in full if the transferor shareholders received 20 per cent or more of the acquiring corporation's stock.[13] If they received less than 20 per cent the net operating loss would be reduced by 5 per cent for each 1 percentage point less than 20 per cent.[14] The shareholders of the selling corporation, however, normally would not be interested in a tax-free reorganization type of disposition, except perhaps as to part of the consideration.

We have covered the extremes in the two preceding discussions, namely, acquisitions of rich and debt-free corporations, the sellers of which are motivated by desire to liquidate for estate tax purposes, to avoid accumulated earnings tax, or to "pick up their chips"; and corporations at the other extreme that have been unprofitable and possibly have sustained net operating losses which can be utilized by a purchaser. The great majority of acquisitions are somewhere between. Usually some of the attributes of both will be found, and in such cases it is a matter of weigh-

11 IRC P 334(b)(2).
12 IRC P 368(a)(C).
13 IRC P 382(b)(1).
14 IRC P 382(b)(2).

ing the advantages of a Kimbell-Diamond transaction in which possible basis may be lost, but in which the debt will become associated with and a part of the operations of the corporation, and of retaining a subsidiary which may produce a personal holding company and thus require a consolidated return. Each situation will repay intensive study in order to select the best type of organization and to determine the best number of subsidiaries with which to operate, thus enabling the company to earn the maximum and to pay the minimum tax in the earlier years while the debt incurred in the course of acquisition is being liquidated.

CASH RAISING DEVICES

In some cases, where the purchasers are in low brackets or where the initial earnings are likely to be small, it may be advisable to operate in non-corporate form; but where earnings are material or the purchasers have substantial taxable incomes, corporate organization is required as a practical matter. Such devices as sales and lease-backs are helpful in producing cash and generating deductions in the earlier years. Debt is preferable to equity ownership because of the deductibility of the interest, which dividends lack. One common attribute of this type of acquisition is its freedom from danger of the excess earnings tax, because in such cases the company needs all of the money that it can get for operation and for debt retirement.

ACQUISITIONS BY CHARITABLE ORGANIZATIONS

This discussion would not be complete without some reference to plans currently in use under which tax-exempt organizations – particularly churches – purchase the stock of a profitable and fat corporation and pay for it out of earnings. The general mechanics of this type of transaction are as follows: All of the stock is purchased at a high purchase price and the acquired corporation then is liquidated. A nominal amount (perhaps 10 per cent) is paid down and the balance paid out of rent received by the church from the corporation created to lease the assets acquired on liquidation. The new corporation generally has the same management as the purchased and liquidated corporation and salaries agreed upon are paid for such management. Eighty per cent of the net income before taxes is paid to the church as rent for the properties leased to the new corporation. The remaining 20 per cent of net income is retained by and taxable to the new corporation. The church receiving the 80 per cent as rent is not taxable (it is an exempt organization) and is able to pay a large percentage of the amount so received to the sellers on account of the purchase price. Frequently no interest is required on the deferred payments in such transactions, the sale price being fixed at a figure which will approximate the book value or agreed value of the business, and the payout is much more rapid than could have been achieved if the acquiring corporation were subject to income tax. Whether such transactions will continue to be approved or attacked by the Treasury Department is open to question, but presently there appear to be no legal bases for challenging the validity of such transactions.